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SARADHA SCAM: THE CULMINATING POINT OF HUMAN GREED AND GOVERNMENTAL LAXITY

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Abstract

The insatiable nature of human beings is a boon for the flourishing of business of ponzi schemes and there appears no setback for their future prospects as well due to the unusually high returns, they offer. Not very unusual, the outbreak of the Saradha scam pointed out the glaring loopholes in the traditional banking system and was the awakening call for the Indian government. It was a magnanimous scandal which shook the very foundation of Indian economy. Political endorsement served as the key factor for mushrooming of scams like Saradha. Thousands were duped, their confidence broken, their savings robbed as ultimately their savior turned out to be their backstabber. Saradha working under the garb of a chit fund turned out to be an illegal collective investment scheme. This scam brought to light the lacuna in the investigation procedure and marked the absence of co-operation between the different regulatory authorities probing its' working. Has this scam taught people a lesson and the measures undertaken by the government proved to be adequate, only time will tell.

Key Words: Ponzi Scheme, Saradha, Chit Fund, Collective Investment Scheme, SFIO, ED, CBI.

Introduction

A man is incapable of comprehending any argument that interferes with his revenue ~ Renee Descartes.

Human beings are complex creatures, so there are complex motivations for what people do. The emerging field of emotional finance teaches that one often deals with this conflict by avoiding what one doesn't want to know- one suppresses these feelings – becomes unconscious. There is a conflict between the outcomes and returns one wishes for and cold and hard reality.[1] The term "Ponzi Scheme" is named after Charles Ponzi, a man convicted for multiple fraudulent schemes in Boston in the 1920s.[2] Before the time of Charles Ponzi, the primary inducement for people to invest in ponzi schemes has surely been that the "operator promises high financial returns that are not available through traditional investments".[3] Ponzi scheme has no exact definition, since they manifest a kaleidoscopic variety of configuration.[4]

What are ponzi schemes?

A type of pyramid plot[5], ponzi schemes involve apparently legitimate investment entities.[6] Rather than engaging in any underlying business or profit

[1]Penelope Jenkins, *Why Investors fall for Ponzi Schemes*, U. WARWICK, http://www.2.warwick.ac.uk/knowledge/business/ponzischemes/ (last updated on 26th Sept. 2014).
[2] Black's Law Dictionary, 1278 (9th ed. 2009).
[3]Jory & Perry, *Ponzi Scemes: A Critical Analysis*, J. FIN. PLAN, http://www.onefpa.org/journal/Pages/Ponzi%20Schemes%20A%20Critical%20Analysis.aspx (last updated on 26th Sep. 2014).
[4] Manhattan Inv. Fund Ltd. v. Gredd, 397 B.R. 1.
[5] Eber hard v. Marcu, 530 F.3d 122.

producing activities for investors, the entity pays earlier investors a return using the funds of subsequent investors.[7] Since this method of paying interest often generate falsely high returns, the scheme attracts further investors,[8] and the fraud continues until new investors dry up and the scheme disintegrates. The collapse of the ponzi scheme results in a "pyramiding of the liabilities" to be dealt with in bankruptcy.[9] Later investors as well as those who reinvested their earnings over time, often loose not only the return on investment they thought they had made but their entire principal investments.[10]

Ponzi schemes inevitably inflict financial damage on most of their investors and divert savings from productive investment. If left unchecked, they can grow exponentially and cause broader economic and institutional damage as well, undermining confidence in financial institutions and regulatory authorities and creating fiscal costs if bailouts occur. They can even lead to political and social instability when they collapse.

What motivates reasonably intelligent people to invest in ponzi schemes?

Ponzi victims run the gamut, from ordinary citizens to sophiscated, intelligent financial professionals. One criticism they commonly face that they "should have known better".[11] The returns were so high, and they came so fast, that the victims should have known the scheme was "too good to be true".[12] The

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[6] United States v. Moloney, 287 F.3d 236.
[7] *supra* note 2.
[8] *Id.*
[9] United States v. Weiner, 988 F.2d 629.
[10]Karen E. Nelson, *Turning Winners into Loosers: Ponzi Scheme avoidance law and the inequity of clawbacks, Minnesota Law Review* :http://heinonline.org, (last updated on 24 sept 2014).
[11] Saul Levmore, *Rethinking Ponzi- Scheme Remedies in and out of Bankruptcy,* B.U.L. Review. 969,-982 (2012).
[12] *Id.*

operator typically represents that such returns are possible "because of his unique skills and investment strategy".[13] The strategy seems to have been a smokescreen, designed to hide what was little more than the crafty shifting of funds from one investor to another.[14]

Enormity of the situation

"*Knowing better isn't easy. Ponzi operators are typically light years more sophiscated than the Nigerian money filter-scams caught by your e-mail spam filter*."[15] ~ Anne Kate Smith.

At its heart there is nothing that new about the Saradha scam. It is not the first Ponzi scam, nor will it be the last.[16] Saradha is portrayed as a confidence scam that duped domestic helps, auto-rickshaw drivers, retired widows and common people out of their savings. It flourishes even more in rural settings where banking options are fewer.[17] It is a tragic story but not an unfamiliar one.[18]

In short, the group's functioning was blatantly illegal and fraudulent. The working of the group in such blatant violation of all regulations and laws

[13]Jory & Perry, *supra* note 3.

[14] Dennis Collins, *Case Study: Bernie Madoff's Ponzi Scheme: Reliable Returns from a Trustworthy Financial Advisor in Business Ethics: GHow to Design and Manage Ethical Organisations*, http://dcollins.faculty.edgewood.edu/pdfdocuments/Madoff%20Case.pdf (last updated on 26th September 2014).

[15]Anne Kate Smith, *The Lure of Ponzi Schemes,*Kiplinger's Press Fin. http://www.kiplinger.com/article/investing/T031-C023-S002-lure-of-ponzi-schemes.html (last updated on 29th September 2014).

[16]*Trust is a commodity: What the underbelly of Bengal's Saradha scam reveals* www.firstpost.com/india/what-the-underbelly-of-Bengals-saradha-scam-is-revealing-about-politicians-industries-1724513.html (last updated on 27th September 2014).

[17] *Id*.

[18] *Id*.

shows a mammoth failure of the regulatory authority of the government, both at the centre as well as at the state level.[19]

For all the talk of financial inclusion, these chit funds exploit the vacuum left by the regular banking system. It is a cruel joke that by any given neighbourhood in a big city will probably have half a dozen bank branches and a dozen ATMs, rural and even semi-urban locations are severely under-served.

What this means is that while wealthy and upper middle-class Indians have access to multiple and safe investment channels-mutual funds, fixed deposits, insurance schemes, poorer Indians are at the mercy of chit-funds and agents who collect tiny sums may be even a few hundred rupees, every month and make unreal promises.[20]

Many people believe the operators, because they initially deliver on their promises by using later contributions to pay very large returns to the initial investors.[21] Others perceive this and therefore find it plausible that the ponzi operator can and will produce similar result for them.[22] This, in turn seduces them to invest.[23]

Once people see their peers "making good money" from the schemes, an irrational optimism of the scheme often sets in. This phenomenon causes rational people to disregard even sensible and persuasive arguments against the scheme.

[19] Subhanil Chowdhury,*The Political Economy of Shadow Finance in West Bengal*, Economic & Political Weekly (2013).
[20]*Id.*
[21]Dennis Collins, *supra* note 15.
[22]*Id.*
[23] R. Alexander Pilmer & Mark T. Cramer, *Swindler's List*, 32-JUN L.A. Law. 22,23 (2009).

Ponzi operators are known to be general donors and regularly contribute to charities, educational institutions and political campaigns.[24] This fosters a "good guy" image, which in turn lead people to trust the operator.[25]

The slickest of the modern ponzi schemers tend to offer returns that, while certainly what investors could expect elsewhere are still low to maintain a whiff of plausibility and thus deter suspicion.

Ponzi schemes are the major reason for this slide in the small deposit schemes. This drop in small savings holding is because of a decline in the interest rates of the schemes one offer. The issue of lowering of the rate of interest on small savings is a direct result of central government policies. With the opening up of the financial sector and the concomitant liberalisation of financial institutions, the ruling establishment has let markets determine financial investments. As a result, various committees of the central government which looked into the issue of small savings suggested that the interest rate should be market-determined, or it should be aligned with the interest rate obtainable on government securities of the same maturity. With lower rates of interest on small savings, and lower financial inclusion, fraudulent companies like Saradha group becomes the obvious choice of the people to deposit their savings.[26]

A Peep into the Saradha scam

"*Every great crisis reveals the excessive speculations of many houses which no one before suspected*." ~ Bagehot.

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[24] Jory and Perry, *supra* note 3.
[25] *Id.*
[26] Subhanil Chowdhury, *supra* note 20.

Saradha is telling a story that is bigger than one about murky financial dealings.[27] Saradha's name does not suggest a collective investment scheme. It suggests trust. Saradha used one of Bengal's most sainted names to establish its trustworthy credentials. From a real estate agent to a media baron, Sudipta Sen's rise was meteoric, to say the least.[28] Mr. Sen is the chairman and managing director of Saradha, a business group built on a chit fund, the collapse of which has left lakhs and lakhs of people in West Bengal and its neighbouring states in the lurch.[29] Another perpetrator in the crime was Debjani Mukherjee. She being the executive director was second-in-command at the office and became the only access key to Sudipta Sen.[30]

The companies that made up Saradha Group were incorporated in 2006. A complicated maze of 338 bank accounts and 224 companies was used by the perpetrators of the Saradha chit fund scam which is alleged to have duped numerous investors of their hard earned monies.[31] In one of the most voluminous investigations being carried out by the agency involving lakhs of multi-layered transactions, it was allegedly found that "more than 90 per cent of such companies existed only on paper and only 17 companies out of the 224 companies actually had carried out some business." Initially, the front-line companies collected money from public by issuing redeemable preferential bonds and secured debentures.

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[27]Sandip Roy, *Trust is a commodity What the underbelly of Bengal's Saradha scam reveals*, www.firstpost.com/india/what-the-underbelly-of-Bengals-saradha-scam-is-revealing-about-politicians-industries-1724513.html (last updated on 27th Sept. 2014).

[28]Digbijay Mishra, *Who is Sudipta Sen*, BUSINESS STANDARD, April 22, 2013.

[29] Monideepa Bannerjee, *Sudipta Sen: The man with 'three wives and five houses'*, http://www.ndtv.com/article/people/sudipta-sen-the-man-with-three-wives-and-five-houses-357659 (last updated on 27th September 2014).

[30] Soudhriti Bhabni, *Saradha chit fund chief Sudipta Sen's letter to CBI can singe big names,* INDIA TODAY, April 26, 2013.

[31] *300 bank accounts, 200 firms used to commit Saradha scam: ED*, BUSINESS STANDARD, September 26, 2014.

Under Indian Securities regulations and section 42 of the Indian Companies Act, 2013 a company cannot raise capital from more than 50 people without issuing a proper prospectus and balance sheet. Its accounts must be audited. It must also have explicit permission from the market regulator Securities and Exchange Board of India.[32] The rest, investigators claimed, were floated as “dummies” to act as cover for unleashing the alleged Ponzi scheme. It was a text-book example of “trading without capital”.

The laundering amount in this case amounts close to Rs 1,983.02 crore. Investigations have revealed that the companies were floated with definite equity basis, so as to conceal the collection of money from investors. The Ponzi scheme used its wide collection of agents to amass huge sum of money from the public. The people were promised that they would be paid an interest of 18% if they invested in the group’s scheme for 3-5 years. Out of every Rs 100 mobilized from public, an amount of Rs 35 went into payment of commission and performance bonus to the agents mobilizing the investment.[33]

The SEBI had warned the Government of West Bengal, since early 2011 that several companies in Bengal were running collective investment schemes without obtaining a certificate of registration from it. The articles of association of Saradha contained varied objects ranging from construction to trading to retail to automobile to home appliances but not deposit collection. A little degree of official alacrity would have easily established that something was wrong.

[32] Acharya Namrata, *In Bengal's grey 'money market', Saradha is just one*”, BUSINESS STANDARD, April 26, 2013.

[33] *Saradha Agents earned 35% commission on deals: ED*, BUSINESS STANDARD, September 26, 2014.

However, investigations have revealed that even before Saradha was registered, queries were made about its prospects as a Non-banking Financial Institution (NBFC). The ROC however categorically declared that NBFCs are not allowed to raise deposits directly from individuals. They can source funds from banks or issue shares and debentures after concurrence from Sebi. However, it was apparent that Saradha was openly collecting deposits — so much so that it is still widely but erroneously referred to as a “chit fund”.

Sudipta Sen was planning to apply for a bank licence for a capital of over Rs. 1000 crore funds allegedly cobbled from the money of numerous duped investors. The business venture, which could have been named ‘Saradha Bank”, was being allegedly planned as a new market foray of the diverse group.[34]

Saradha Scam: A Political Intrigue?

The Saradha Group was set up under the nose of the Left Front Government and continued to flourish after the Trinamool Congress came to power in 2011. It had a way of purchasing support and political protection. Political parties in the state are squabbling over whose patronage he enjoyed as his ponzi scheme flourished unhindered. [35]

The two Trinamool MPs who had business dealings with it began as critics of the chit fund company. One of them is a media baron, Mr. Srinjoy Bose whose family made its fortune running an extortionate and criminalised stevedore

[34]*Sudipta Sen was mulling licence for ‘Saradha Bank’ from scam funds*, news.oneindia.in/india/sudipta-was-mulling-licence-for-saradha-bank-from-scam-funds-1516865.html (last accessed on 28th September 2014).
[35] Monideepa Bannerjee, *supra* note 31.

syndicate at the Kolkata Port. The second MP, Mr. Kunal Ghosh is a journalist who wrote strong articles against Saradha before signing up with it for an exorbitant monthly fee.[36] Another perpetrator in the crime is Madan Mitra, the transport minister of Bengal who was arrested by CBI recently for allegedly granting favours to Saradha.

It stands to reason that Saradha had a similar relationship with the CPI(M) leadership. Indeed, its initial distribution network in rural Bengal is believed to have mirrored or plugged into the CPI(M) cadre network. The case of the Congress MP, Mr. Matang Singh a Minister of State in the UPA Government, who switched from being an opponent of Saradha to praising it effusively, is also telling.

While West Bengal's broader political climate may be responsible for swindles such as Saradha, it is not as if Chief Minister Mamata Banerjee can get away with simply blaming 34 years of Left misrule. While that point of a toxic legacy is well taken, she has been at Writers' Buildings for two years now. There was a surge in Saradha's operations in this period. Important political and cultural faces linked to the Trinamool regime came to lend their name to Saradha.[37] Political commentators are speculating that what the Bofors scam proved to Rajiv Gandhi, Saradha scandal might reap the same fruits for Mamata Banerjee.

Measures for the sake

The Global Adult Tobacco Survey (GATS) India released by the Union Ministry of Health and Family Welfare revealed that about 36.3% of West

[36] Digbijay Mishra, *supra* note 30.
[37] Ashok Malik, *supra* note 21.

Bengal's population uses a tobacco product in one or other form in a bid to cut down on a consumption of tobacco products. The office of Commissioner of Food Safety, recently issued a notification prohibiting manufacture, storage, sale and distribution of gutka and pan masala and other products containing tobacco or nicotine as ingredients for a period of one year with effect from 1 May 2013.[38]

Later Government of West Bengal in 2013 announced a controversial Rs 500 crore relief fund for the low income depositors of the Saradha Group.

The Government also introduced a 10 per cent additional tax on tobacco products to mop up the revenue.[39] This imposition of additional tax raised a hue and cry among the anti-tobacco groups calling it a great discouragement and the then RBI Governor D. Subbarao stating it as unfair.

After the collapse of the ponzi scheme the West Bengal government formed a four member judicial inquiry commission headed by Justice Shyamal Kumar Sen to probe the scam and it was named Justice Shyamal Sen Commission of Inquiry (Saradha Group of Companies and other similar companies). The government also set up a special investigating team under section 36 of the CrPc, with officers drawn from WB CID and Kolkata Police to pool all the criminal cases and expeditiously probe the investigation. However the government staunchly opposed all investigations by federal investigative agencies like CBI, ED and SFIO, expressing complete satisfaction over the investigation of state administered agency.

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[38] *Anti-tobacco group raises hackels over mamata's smoke joke, indo asian news service*, https://in.news.yahoo.com/anti-tobacco-group-raises-hackels-over-mamata-smoke-133056659-finance.html (last updated on 28 Sept 2014).

[39]*Saradha chit fund scam ,nightmare for WB CM, TMC Leader Mamata Banerjee: Explained*, http://news.oneindia.in/india/saradha-chit-fund-scam-nightmare-for-mamata-banerjee-tmc-wb-cm-explained-1519502.html#infinite-scroll-1 (last updated on 28 Sept 2014).

Is CBI the 'need of the hour'?

The state government only conceded to a federal investigation after Supreme Court ordered it to. The constitutional bench of the Supreme Court in ***State of West Bengal and Ors. v. Committee for Protection of Democratic Rights, West Bengal and Ors.***[40] said that the Constitution of India under Articles 32 and 226 confer the power of judicial review to the supreme court and high court respectively.

The court also said that if in terms of entry 2 of list II of the Seventh Schedule on the one hand and entry 2A and entry 80 of List I on the other, an investigation by another agency is permissible subject to grant of consent by the state concerned, and in an exceptional situation court would not be precluded from exercising the same power which the Union could exercise in terms of the provision of statute the exercise of such power by the constitutional courts would not violate the Doctrine of Separation of Power. Infact, if in such situation the court fails to grant relief, it would be failing in its constitutional duty.[41]

This extraordinary power should be exercised in situations where it becomes necessary for the court to provide credibility and instill confidence in investigations or where the incident may have national and international ramifications or where such an order is necessary for doing complete justice and enforcing the fundamental rights.[42]

As the activities of these companies were found to be in serious violations of the Companies Act, the Sebi Act, and several provisions of the Indian Penal

[40] (2010) 3 SCC 571.
[41] Subrata Chattoraj v. Union of India and Ors., 2014 (5) SCJ 586.
[42] *Id*.

Code, Such Sections are 107 (Abetment of Crime), 120B (Criminal Conspiracy), 403 (Dishonest misappropriation of property), 406 (Criminal breach of trust), 409 (Criminal breach of trust by public servant), 415 (Cheating), 418 (Cheating with knowledge that wrongful loss will be caused), 419 (Punishment for cheating by personation) and 477A (Falsification of accounts).

Besides, prosecution would also be initiated by the state governments for violations of the Prize Chits and Money Circulation Scheme (Banning) Act, while the probe report and necessary evidence would be shared with CBI.

The Supreme Court has called for collaboration between the CBI and the State Governments in order to avoid duplication of proceedings.[43]

Suggestions

"The essence of the Ponzi Scheme is not statistical, it is psychological."

- Bank lending in India is only 50% of GDP and, of this nearly a quarter is appropriated by the government. In any decent economy, bank lending is well above 100% of GDP (200% for OECD and 340% for Japan). Since India has a long tradition of lending and borrowing money, credit requirement cannot be lower than that for a normal economy. India should try to increase its bank lending so that it goes above the GDP.

[43] *Saradha Was Running Ponzi Schemes, to Face Prosecution: Serious Fraud Investigation Office,* http://www.ndtv.com/article/india/saradha-was-running-ponzi-schemes-to-face-prosecution-serious-fraud-investigation-office-591963 (last updated on 28 Sept. 2014).

- Saradha and similar outfits exist because the vast majority of Indians do not have access to formal finance. Banks remain remote and intimidating, beyond access for most would-be depositors and borrowers. People have to give up work for a day, trudge a long distance to the village that has some banking outlet or the other - over two-thirds of all villages do not have a banking presence - and meet formalities that normally they would not be able to. That's why they take recourse to informal means of saving and borrowing. So adequate amount of banking facilities should be provided and proper orientation should be given to people for availing the banking facilities.
- Small savings schemes are designed to provide safe and attractive options to the public and at the same time mobilize resources for the development. The government should try to offer an increased rate of interest for these schemes, and carry out campaigning to promote the inherent benefit these schemes carry. ***Firstly***, as government schemes they are more secured as they offer proper returns and have less chances of a failure in the near future. ***Secondly***, most of these schemes are tax free, as they are exempt from taxation.
- Broad financial literacy programmes can help stop unregulated schemes. In addition, it is crucial that the regulators keep the general public informed, through general warnings regarding the methods used to defraud investors and the need to question the potential investments' financial viability and invest only through license entities. For this purpose, the National Savings Organisation (NSO) which was established in 1873 is responsible for national level promotion of small savings schemes through publicity campaigns and advertisements

through audio, video as well as print media. This organization should be made active both at the national level and regional level.

- A ponzi scheme may constitute a violation under several financial laws, which can be pursued by more than one regulator. Close dialogue with the criminal authorities can lead to more effective investments. Financial regulators need effective mechanisms for the exchange of information and co-operation on curbing unregulated schemes. There should be proper collaboration between SEBI, ED, SFIO and the respective state police authorities to exchange information in order to make the mechanism more effective and investor friendly.
- Financial regulators need sufficient independence to act without additional approval from the government, even if the schemes have tacit support of the members of the government. And the regulatory framework must protect staff and commissioners against law suits arising from the execution of their duties. SEBI and CBI should remain free from all political intrusion and work without any restraint.
- Financial regulators should employ the civil or administrative remedies at their disposal while also submitting their files to the criminal authorities. Regulators should stand ready to help the authorities to build a criminal case, or bring charges themselves.
- Completing a full investigation to bring civil, administrative, or criminal charges can take a long time, during which scheme operators or investors' money may disappear. Once a regulator has reasonable evidence of the existence of a fraud perpetrated by a Ponzi Scheme, it should immediately seek emergency restraining orders, such as freezing assets, to protect investors' interests while the investigation continues.

Conclusion

Recently Ponzi Schemes have varied widely in size, which may reflect a variety of factors, but the speed and effectiveness of the regulatory response is clearly crucial. The lack of a strong regulatory response along with underdeveloped formal financial institutions, has allowed Ponzi schemes to develop and continue operating even after many red flags have been raised, and is a reflection of a broader problem: the challenge of developing credible enforcement programs. Many regulators in developing countries lack the necessary enforcement tools, resources, and sometimes political independence to cope with financial misconduct, including the operation of Ponzi schemes. In a global financial market, regulators must be able to exchange information and cooperate with one another. This has proven critical in combating unregulated schemes, given their demonstrated ability to relocate from one jurisdiction to another. But for many developing countries regulators, legal limitations mean such cooperation is still beyond their reach.

Ponzi schemes are a concern around the world, but especially in countries where relatively less developed regulatory frameworks are unable to contain their exponential growth. The key lesson is to act early before schemes gain momentum and imperil unsuspecting investors.

Ponzi schemes inevitably inflict financial damage on most of their investors and divert savings from productive investment. If left unchecked, they can grow exponentially and cause broader economic and institutional damage as well, undermining confidence in financial institutions and regulatory authorities and creating fiscal costs if bailouts occur. They can even lead to political and social instability when they collapse. So, the need of the hour is a proper co-operative atmosphere and awareness among people so that ponzi schemes are razed right from their inception.